

USAWC STRATEGY RESEARCH PROJECT

**RUSSIA AND EMERGING FREE-MARKETS: OPPORTUNITY OR THREAT?**

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## **ABSTRACT**

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Given the current situation in Iraq, the war on terrorism, and globalization it would seem that a democratic free and economic secure Russia along with an economic secure China would enhance the President of the United States National Security Strategy (NSS) to defend, preserve, and extend the peace--an opportunity to reduce threats otherwise posed by economically weak nations. Understanding the importance of economic security and its effect on emerging markets is valuable to the strategic thinker as an application in developing policy to reduce, and ultimately prevent, conflict; or its relevance to long term stability in post-conflict operations.

This Strategy Research Project (SRP) analyzes U.S. strategic objectives of supporting emerging markets along with the opportunities, vulnerabilities, and threats of such support. The emerging market process of the Russian Federation is analyzed as to its potential effect vis-à-vis a national security strategy. Questions addressed are: What is the U.S. national interest in the economic openness of Russia? What would a U.S. grand strategy to achieve this goal look like? What are the U.S. strategic goals? What should one conclude from such a strategy?



## RUSSIA AND EMERGING FREE-MARKETS: OPPORTUNITY OR THREAT?

Following the collapse and breakup of the Soviet Union, the Russian Federation was formed as an independent state in 1991 in addition to 14 other independent states, such as Albania and Bulgaria.<sup>1</sup> These former states started out with central command authority economies inherited from the former Soviet Union. However, it was realized that economic stability and security could be accomplished only through a free market economy. This would require significant changes and assistance to transition to such an economy.

President Bush conveys broad national security objectives in his opening policy letter on National Security Strategy in which the United States, "[W]ill defend the peace by fighting terrorists and tyrants...preserve the peace by building good relations among the great powers...[and] extend the peace by encouraging free and open societies on every continent."<sup>2</sup> The strategy or policy cites, among other objectives, Russia's move towards democracy and her partnership in the war on terror and China's move towards open markets:

Russia is in the midst of a hopeful transition, reaching for its democratic future and a partner in the war on terror. Chinese leaders are discovering that economic freedom is the only source of national wealth. In time they will find that social and political freedom is the only source of national greatness. America will encourage the advancement of democracy and economic openness in both nations, because these are the best foundations for domestic stability and international order.<sup>3</sup>

Given the current situation in Iraq, the war on terrorism, and globalization it would seem that a democratic free and economic secure Russia, along with an economic secure China, would enhance the President of the United States National Security Strategy (NSS) to defend, preserve, and extend the peace--an opportunity to reduce threats otherwise posed by economically weak nations. Understanding the importance of economic security and its effect on emerging markets is valuable to the strategic thinker as an application in developing policy to reduce and, ultimately, prevent conflict. Economic security is also relevant to long term stability in post-conflict operations.

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## U.S. National Interest in the Economic Openness of the Russian Economy

*The National Security of the United States* recognizes the opportunities that economic growth through free markets and trade bring. Its underlying premise is that “[a] strong world economy enhances our national security by advancing prosperity and freedom in the rest of the world.” This premise and a strategy realize that:<sup>4</sup>

The lessons of history are clear: market economies, not command-and-control economies with the heavy hand of government, are the best way to promote prosperity and reduce poverty. Policies that further strengthen market incentives and market institutions are relevant for all economies—industrialized countries, emerging markets, and the developing world.<sup>5</sup>

It is from understanding these broad opportunities that an analysis of U.S. and Russian interests, their intensity, and the issues and challenges can be understood. This analysis starts with Russia’s desire for membership in the World Trade Organization (WTO).

The WTO’s goal “is to improve the welfare of the peoples of the member countries.” Through the establishment of agreements with member countries on a number of areas, such as intellectual property, goods and services, and dispute settlements, conditions are established for open markets and their continued reform. The agreements must be ratified by the legislatures of the member countries. The agreements then become the legal groundwork for international commerce.<sup>6</sup> This is a simple description of an organization whose benefit of membership is enormous due to the concomitant responsibilities. These responsibilities require actions that are in the best economic interests of the 148 member nations.<sup>7</sup>

Membership responsibilities require a number of reforms by the prospective member. In the case of Russia, such reforms include tariff and customs policy, technical standards, information technology agreements, service agreements [e.g. telecommunications, financial, distribution centers providing truck or delivery services, etc] to name a few.<sup>8</sup> The outcome of such reforms is the establishment of conditions enabling an open market. This is clearly in the best national interests of Russia. Open markets enable reform of sectors formally operated by either monopolies or state run industries, which is often the case with new democracies, such as Russia. WTO membership and open markets [free economy] would benefit Russian interests through the promotion of reform, economic growth, and contribution to peace.<sup>9</sup>

These Russian interests share a relationship with the U.S. interests of: Security for the Homeland, Economic Well-Being, and Promotion of Values.<sup>10</sup> The level of intensity of U.S. interests regarding Russian efforts for a free market economy should be viewed as important regarding Security for the Homeland and Promotion of Values and beneficial to Economic Well-Being.

A democratic Russia that is economically secure will help bring stability to the region as well as encourage mutual cooperation, prosperity, and democracy among the independent states of the former Soviet Union. It also allows Russia, rightfully, as a great power [for example, member of the United Nations Security Council, a G-8 member, partner in the multilateral negotiations with North Korea, partner in the war on terror], to be an even greater and effective nation contributing to the international arena. These contributions and potential for greater contribution are important to U.S. interests of Security for the Homeland and Promotion of Values. Potential future economic benefits to the U.S. should be viewed as a peripheral, given the enduring strength, diversity, and ingenuity of the United States' economy.

Although Russia's Putin administration firmly supports WTO membership and is working towards that end, some friction remains within the Russian government and private sector. Also, some external friction remains with Australia, Canada, and the European Union regarding agricultural trade and health measures and with the U.S. regarding the opening of the banking system to foreign investment and enforcement of intellectual property rights.<sup>11</sup> There is also concern in Russia's foreign direct investment (FDI) in the Commonwealth of Independent States (CIS), an organization consisting of 11 of the 15 former Soviet republics.<sup>12</sup>

Part of this concern is the perception that the Putin administration is hostile towards certain Russian business sectors causing more investment to move abroad. This perception is the result of the Putin administration's enforcing corporate tax laws and corporate governance. However, only one fifth of Russian FDI is made in the CIS and the investments offer practicality. Russian FDI is not illegal or unethical. The practice is an acceptable means of reducing risk exposure through diversification. Such investment opportunities offer a reasonable or better rate of return on investment, and mitigate the affects of a downturn in the Russian economy.<sup>13</sup>

Following a financial crisis in 1998, the Russian economy has experienced growth in each of the past seven years. Gross domestic product (GDP) has risen more than 50% with an average annual growth rate of 7.2%. If this rate is sustained, the Russian GDP would double in 10 years. However, new wealth must be created and economic growth accelerated if Russia is to develop, as it still suffers from impoverishment.<sup>14</sup> Also, a large portion of the Russian economy relies heavily on oil and gas investments [the largest sectors are energy, metallurgy, and engineering]. These energy investments generate 25% of the GDP and 50% of export earnings. The volatility of these markets adds risk to an economy that must grow significantly to lift itself out of poverty.<sup>15</sup> The growth must come from the expansion of other sectors of the economy and the ability to rely on exports other than energy.

U.S. interests are best served by supporting the Russian goal to move toward a free market economy and the clear opportunities it contributes to United States interests [Security for the Homeland, Promotion of Values, and Economic Well-Being], as well as global interests. Not supporting Russia risks an economic collapse and further weakening of the government. This weakness sets conditions in which the federal government is unable to provide the revenue necessary to support the public infrastructure that provides basic services—schools, hospitals, fire, police, roads, etc. A weak government also sets conditions for lawlessness and corruption. The lack of services, lawlessness, and corruption greatly threaten the end of the Russian federal government and undermines U.S. interests, particularly U.S. and regional security.

The question is not one of supporting Russia, but how to support the Russian Federation's movement to continue to implement a free and open market. The following discussion looks at issues regarding the macro-economic challenges and opportunities faced by Russia. Understanding these macro-economic issues is necessary in order to have an appreciation for Russia's efforts as well as an awareness of the complexity of the necessary undertakings by a former superpower that is still formidable to transition to a free-market economy.

The success of Russia's efforts to become a free market economy would be improved by WTO accession. The accession and benefits of membership would certainly bolster Russia's economy, thus; improving her security. However, it would also benefit the region's other former command market economies as the rising tide of prosperity lifts the economic security boats of other Central Asian states. Such prosperity is clearly in the interests of the United States and serves as an historic reference supporting the benefits of free market economies.

The Central Asian States continue to struggle with reform and free enterprise, while their people clearly desire to participate in the growing prosperity enjoyed by other former Soviet countries. The risks associated with failure of these states include regional instability, drug trafficking, smuggling and safe haven for terrorists.<sup>16</sup>

Russia demonstrated her importance during the U.S. efforts to defeat the Taliban in order to remove Al-Qaeda forces in Afghanistan. Russia supported the U.S. efforts by joining the alliance and providing logistical support. This support aided the U.S. to move personnel, equipment, and supplies to countries bordering Afghanistan.<sup>17</sup>

A look at China reveals the effects that WTO membership can provide. China has experienced economic growth, producing sizeable trade surpluses.<sup>18</sup> These surpluses are the result of manufacturing, as opposed to Russia which has relied on energy, metallurgy, and engineering. China's main effort in joining the WTO was the security of access to U.S. markets. Although China enjoyed a bilateral most favored nation (MFN) status with the U.S., the



pressures of anti-dumping were taking root and putting China at risk of unilateral action by the U.S. for example, quotas, tariffs, or both).

Another effect is the enabling of closing loss-making state owned enterprises. China and Russia are burdened with a number of revenue losing entities. These burdens require restructuring or closing. However, the political, social, and initial economic costs are tremendous. Belonging to the WTO gives the political entity greater impetus with which to rid itself of these burdens by “fulfilling” an external requirement.<sup>19</sup>

The greatest effect is the economic growth as measured by FDI, GDP, and general living standards. A prediction of China's economic vitality as a result of WTO membership compared to not being a WTO member provides encouragement. GDP is predicted to be almost 30% higher by 2020. This optimism is predicated on four conditions as a result of WTO membership:

- The perception of reduced risk to foreign investors.
- Gains through market efficiencies as a result of reduced tariffs and quotas.
- Increased productivity.
- Conditions attracting foreign investment in services and trade.<sup>20</sup>

WTO membership does present a few considerations regarding internal Russian politics and policies. Although membership would open markets to Russia, it causes Russia to reciprocate by opening its markets to foreign access and competition. This would include markets in the manufacturing and services sector.<sup>21</sup>

Despite not being a member of the WTO, Russia does enjoy MFN status with many developed countries operating free markets. Unfortunately, Russia is still considered a state-trading economy. This status restricts market access and creates vulnerabilities such as anti-dumping charges. These vulnerabilities can lead to protectionist measures such as voluntary export restraints (VER) or import duties. The status of being a state-trading economy fuels such charges as sectors may enjoy hidden state subsidies, whether incorrectly or not. Replacing the status of state-trading economy would provide Russia better treatment.<sup>22</sup>

Another consideration involves the pricing of domestic energy—gas, oil, electricity—by Russian producers. Domestic energy prices are far less than those of the prevailing world markets. These below market prices hold true for consumer prices (household) and producer (business). Aside from causing consumers to be wasteful (little incentive to be energy efficient), anything produced by Russia that is energy intensive is, therefore, viewed as being subsidized. This results in immediate charges of anti-dumping claims by trading partners. Thus, energy pricing is a domestic issue Russia will need to address in its desire for WTO membership. This

will produce internal political pressure, but the external lever of WTO membership (similar to China) should result in sound energy policies.<sup>23</sup>

Another consideration is manufacturing in the medium and long run. Although Russia is fortunate to have energy and raw materials for export, it must expand its manufacturing across other sectors. Energy and raw materials are abundant in the short term and contribute greatly to the Russian GDP; however, a long term view must be taken. As energy and raw materials dwindle and become more difficult and costly to extract, Russia will need to rely more on its manufacturing and the revenue that manufacturing export contributes. Improvements in manufacturing would undoubtedly foster improvements in services; for example, banking and telecommunications, as a by product.<sup>24</sup> Again, WTO membership will establish conditions leading to domestic policy formulations.

Another consideration is the level of FDI in Russia. Through 1999, Russia accumulated almost \$20 billion or \$135 per capita in FDI. A comparison of other transitional economies reveals greater success, particularly in terms of the per capita level investment. Hungary attracted \$19.8 billion/\$1,967 per capita, Poland \$20.4B/\$1,612 per capita, and the Czech Republic \$16.5 billion/\$1,612 per capita. Most of Russia's FDI inflow has been in a narrow sector involving natural resources and the machinery and equipment related to the processing of those resources.<sup>25</sup> Russia must do better in attracting FDI if it is to expand other sectors of its economy, such as manufacturing, services, and telecommunications.

The leading cause for this problematic attraction of FDI is domestic policies, particularly those affecting privatization, favoring workers and managers (insiders) and the economic crime and corruption, the bias of interests group influence, jurisdiction issues and confusion between the federal government and regions, and non-monetary transactions. Despite the enactment of laws to promote FDI, investors are not yet confident enough to make large investments, to include Russian investors whose capital flight into the FDI of other countries is a worrisome indication of lack of confidence.<sup>26</sup> However, through the WTO accession process, there is the prospect of a better future for investment inflows. As reforms continue to transition Russia from a state-trade economy towards a free market economy, it is only a matter of time before reform commitments will take hold producing new processes and institutions. The resulting effect will be a climate of transparency and accountability that should greatly improve Russia in the years to come and attract much needed investment that will further propel Russia into an eventual free-market society.

### U.S. Grand Strategy

The U.S. strategy supports Russian WTO membership using the diplomatic, information, and economic elements of power. The economic element is the lead element as Russian WTO membership effects trade policy and its sub elements of trade promotion, sanctions, alliances, and economic development.

Diplomatic element resources would focus efforts on advocacy within the diplomatic community, to include U.S. embassy support to U.S. officials assisting with WTO negotiations and implementation. Diplomatic support is also provided to governmental organizations and non-governmental organizations [for example, U.S. and Russia Chamber of Commerce and the United States Federal Reserve Bank]. Direct assistance would be the Department of State, United States Agency for International Development (USAID).

The USAID's vision is a Russia that is a strong, democratic, and reliable partner for the U.S. on issues of global importance. This would be accomplished through engagement and assistance on a broad series of issues. Regardless of the numerous issues, economic security of Russia will enable the USAID to realize greater success within the context of its much broader vision, along with the goal and strategy associated within that vision.<sup>27</sup>

Information element resources would act similarly to diplomatic elements and include public policy statements of support and information operations explaining the mutual U.S. and Russian interests served, as well as the benefit Russian WTO membership provides to the world community. This is also an opportunity to bolster the importance of an economically secure Russia and blunt criticism of those skeptical of the WTO as a threat to sovereignty and individual rights. [NOTE: The criticism is addressed in greater detail as part of a discussion on risk to U.S. interests under Strategic Goals].

Economic element resources would be the prevailing element of power to carry out U.S. objectives supporting Russian Federation WTO accession. U.S. government resources would consist primarily of two sources: the Office of the United States Trade Representative and the U.S. Department of the Treasury technical assistance through the Under Secretary for International Affairs and the Deputy Assistant Secretary responsible for Eurasia and Western Hemisphere.

The Department of the Treasury's office for International Affairs promotes U.S. economic prosperity by supporting financial stability and sound economic policy abroad. It accomplishes this through constant monitoring and analysis of global economic and financial trends and sharing the analysis of foreign governments, as well as financial market entities and

participants.<sup>28</sup> However, this agency supports the effort. The primary U.S. actor is the Office of the United States Trade Representative (USTR).

The USTR has responsibility for implementation. As the lead agency or main effort, it will coordinate and conduct the primary economic power element as well as coordinate the diplomatic and information supporting elements. The USTR's role in Russian Federation WTO accession is consistent with U.S. trade policy of opening markets in order to create opportunities for higher living standards—also consistent with WTO goals of improving living standards—for families, workers, businesses, and consumers. The USTR develops and coordinates U.S. international trade, commodity, and direct investment policy, and oversees negotiations with other countries. The U.S. Trade Representative, in addition to directing the USTR office, is a cabinet member and ambassador. He also serves as the president's principal trade advisor, negotiator, and spokesperson on trade issues and operates through an inter agency process to developing and carrying out U.S. trade policy.<sup>29</sup> The U.S. takes an active role in developing trade capacity.<sup>30</sup>

"Trade can be a powerful tool for developing countries in building their economies and improving the lives of their citizens," said U.S. Trade Representative Robert B. Zoellick, in announcing the contribution. "Helping countries trade more helps Americans gain expanded access to overseas markets." The United States is the largest single country donor of trade capacity. Total U.S. funding for trade capacity building activities was \$761 million in FY 2003, up from \$369 million in 1999.<sup>31</sup>

The USTR confers with U.S. government agencies through the Trade Policy Review Group (TPRG) and the Trade Policy Staff Committee (TPSC). Members of these groups include representatives from each federal agency and include, among others, representatives from the National Security Council (NSC), Office of Management and Budget (OMB), and the Economic Security Council.<sup>32</sup>

The USTR expertise includes working with the WTO as well as a number of other agencies and advisors outside of the U.S. government, to include such prominent organizations as the United Nations Conference and Trade and Development (UNCTAD), and the Organization for Economic Cooperation and Development (OECD). In developing trade through the WTO, the USTR helps by assisting countries in the WTO accession process to meet the requirements of accession as well as direct assistance. The USTR views Russian WTO accession negotiations occurring along two paths:

(1) bilaterally to open up Russia's markets to U.S. exporters of goods, agriculture and services; and (2) multilaterally to focus on World Trade Organization (WTO) rules issues that include agriculture, customs, protection of intellectual property rights (IPR), treatment of state-owned enterprises, and services. A final WTO

accession package will include: (1) all of the commitments made in bilateral negotiations on market access for goods, agriculture, and services that are provided to all WTO Members; and (2) Russia's commitments to revise its trade regime to adhere to WTO rules that will be included in a multilaterally agreed Working Party (WP) report and protocol.<sup>33</sup>

The U.S. Grand Strategy to accomplish the Russian WTO accession is robust in every sense. However, it is necessary to analyze strategic goals as they apply to the U.S. and Russia. The following discussion looks at the feasibility, acceptability, suitability, and risk of U.S. support for Russian WTO accession.

#### U.S. Strategic Goals

This section looks at U.S. interests in terms of feasibility, acceptability, suitability, and the risk of supporting Russian WTO membership. It also looks at the challenges that Russia faces. The U.S. and many western nations have enjoyed the benefits of open markets and democracy for generations. Looking at U.S. interests without an understanding of the challenges faced by Russia would present an incomplete and faulty analysis, lacking an appreciation for Russian domestic and international issues she must face.

The feasibility or means to support the President's commitment of America's support of economic openness and democratic advancement vis-à-vis assistance of Russian WTO membership is readily available and being carried through the Office of the U.S. Trade Representative (USTR). This office is responsible for coordinating U.S. international trade, commodity, and direct investment policy, and overseeing negotiations with other countries. Among its areas of expertise are World Trade Organization (WTO) issues and expansion of market access for American goods and services.<sup>34</sup> *Acceptability* by the U.S. Congress is strong, particularly considering the 2004 and 2000 House resolutions overwhelmingly rejecting U.S. withdrawal from the World Trade Organization.<sup>35</sup> The U.S. Congress has approved most favored nation status to Russia. Russia has lifted its ban on U.S. beef and poultry. *Suitability* of this policy is very strong, as the U.S. support of Russian WTO membership would ultimately achieve multilateral support for free and open markets in Russia. The U.S. policy is one of active participation, with the U.S. supporting Russia with direct assistance to improve her chances for membership and clearly signals U.S. willingness and cooperation.

The *risk* to U.S. interests in carrying out this policy is considered minimal as the required resources are a U.S. government supporting effort [U.S. assistance to Russian WTO membership] of a Russian Federation main effort to acquire membership. WTO membership requirements place the responsibility requirements on the Russian Federation. Although WTO

membership does not guarantee Russia's economic troubles will be resolved completely or immediately, it does provide Russia much greater opportunity for success in achieving a free and open market economy. Two cases supporting this opportunity deal with the success of Albania and Bulgaria.

Albania enacted over 66 laws to bring Albania into WTO compliance when joining the WTO in 2000. These laws affected changes in agriculture, financial services, intellectual property, technical standards, and other fields. Such compliance enables the country to trade openly in international markets by meeting acceptable standards and provides direct benefit to Albania by providing the efficiencies of a modern economy.<sup>36</sup> Bulgaria, joining in 1996, is an example of longer term effects of membership. "[T]he simple fact of WTO membership has given foreign businesses confidence that Bulgaria is not simply one in a string of unstable post-communist nations, but an open economy where rights are protected. Thus, Bulgaria has seen foreign direct investment flows rise ten-fold since WTO membership."<sup>37</sup>

Despite the issues and challenges faced by Russia, the U.S. must address those critical of supporting a once deadly foe who not only challenged U.S. ideals and values, but threatened the very existence of the United States. Russia still maintains a credible strategic nuclear arsenal that could be used against the United States. Also, there are globalization critics who view the WTO as a tool to exploit the disadvantaged. However, such globalization critics are usually anti-capitalists whose arguments do not flow logically.

The U.S. and Russia will enjoy a more effective and efficient trade relationship beyond the current MFN afforded by the U.S. As Russia becomes a more robust economic partner within the world, its Central Europe region—particularly among the CIS or former Soviet States, and with the U.S., market opportunities will abound. As more markets are opened, the prospect for increased trade in capital goods, agriculture, information technologies, and the service sector offer economic prospects to the U.S. Such an opportunity supports the U.S. interest of Economic Prosperity. However, new challenges will arise in the form of trade and competition challenges. These challenges are best described as the competitive norms by the invisible hand of free-market economies. Such challenges are far better managed through peaceful negotiation than the former costly and deadly alternative of an ideological standoff between communism and capitalism.

Globalization critics and its demonstrators view globalization as capitalism's exploitation of the economically disadvantaged. Their dark and suspicious views ignore the benefits of globalization's ability to raise a country's government and its people from the tyranny of squalor, ignorance, and poverty. They disregard the necessary checks and balances, and controls free

market economies bring about in order to self-regulate continued prosperity. They view trade between rich and poor nations as favoring the rich nation at the expense of a poor nation, and thus oppressing the poor. Therefore, such trade should not occur and organizations like the WTO are wicked institutions favoring the wealthy. There is great irony with their notion to restrict trade between rich and poor nations. Paradoxically it denies rational parties from making free decisions to better themselves through trade regardless of geographical location. It also denies the rights of individuals and organizations to choose their own destinies within the proscribed rules and laws of the citizenry and the government entities they empower.

Water can be viewed as either good or bad, depending on its result. Properly controlled, it is life sustaining; it nurtures crops; cleans our bodies and clothes; extinguishes fires saving us from death, injury, and destruction; and forms the base for many products. Uncontrolled, water's violent flow can take lives, wipe out towns, and destroy crops. A similar analogy regarding control can be made of globalization and capitalism's free markets. Globalization and capitalism bring marvelous opportunities and benefits when properly controlled through the transparency and accountability of societies, institutions, laws, and good governance. In the case of Russia, WTO accession aids free market reforms by requiring the creation of mechanisms for transparency and accountability by the government across all levels [federal through local] and branches.

In the final analysis, Americans can expect economic benefits of free trade with Russia along with the more intangible benefits of greater security. While some may argue various points, it should not be lost on the American people that following World War II the United States help create GATT [the predecessor of WTO] and that the goal of the WTO is to make better the wellbeing of the peoples of its member countries. Therefore, we should not lose sight of this goal and its value, particularly in the context of U.S. objectives regarding Security for the Homeland, Promotion of Values and Economic Well-Being. Russian membership in the WTO is an opportunity for Americans to enjoy greater prosperity and security by encouraging its shared values. To not do so would invite the risk of lost opportunities.

Notwithstanding U.S. interests and risks, Russia must deal with domestic concerns surrounding WTO membership. As noted earlier, as Russia transitions from a state-trade to a free-market economy, reforms involve complex issues regarding macro-economic challenges and opportunities. These reforms will offer opportunities to those willing to take risk and institute reforms that will cast off money losing enterprises while advancing those that are profitable. The challenges will be the various interest groups supporting or opposing changes—the perceived winners and losers.

Those advocating free-market reforms and its benefits, particularly in lifting many Russians out of poverty, face the challenges of those who either favor greater levels of government control of particular sectors or at least resist faster transition.<sup>38</sup> This particular domestic challenge is illustrated with Andrei Illarionov, who was brought on as an economic advisor to the Russian Federation President in April 2000. This move was seen as a commitment by the Putin administration to free-market reforms. However, he resigned in frustration December 2005, perceiving Soviet-era revanchism as Russia has re-nationalized a third of its energy sector, among other issues.<sup>39</sup>

Mr. Illarionov is dissatisfied with the Putin administration's movement from a broadening economic policy of free-markets to a policy of more state control. However, particular political pressures may have forced Putin to make some concessions, resulting in Illarionov's resignation. To be sure, there are concerns within the West of a Russia that stifles domestic freedoms; for example, the passing of a law requiring non-governmental organizations to register and operate under greater restrictions. Renewed military ties with China, sale of anti-aircraft arms to Syria, and ties with Iran are also troubling.<sup>40</sup> The following discussion reviews other pressing concerns and interests.

Thoughtful analysis would rationally favor WTO accession as an economic and political change agent in establishing a free market economy. However Russia must deal with several particular issues involving domestic policy that require substantial changes. These issues must be carefully handled and involve: (a) tariff structures; (b) difficult sectors; (c) services trade; (d) intellectual property rights (IPRs); investments; and trade with the CIS.<sup>41</sup>

Tariff structures are a form of trade restriction. In the case of Russia, its tariffs are complex and number in the thousands. In the late 1990's, import tariffs averaged 13.6%. Adjusting for exemptions and non-collections, it averaged 10%. The tariffs produce revenue that fund public programs; however, if public financing is the argument to sustain such tariffs, then the tariffs should be uniform and collected consistently. An efficient tariff program is less interfering and reduces the vagaries of excessive rates and predilection towards corruption. Through simplification, Russia has been reducing tariffs in terms of numbers and percentages. By 2001, over 30% of products subject to tariffs were grouped into four categories with rates of 5%, 10%, 15% and 20% bringing the average rate down from 13.6% to 11-12%. Domestic interests will favor high tariffs, but protectionism will only impede free market trade, favoring the privileged few while stifling the masses seeking a reasonable living above poverty.<sup>42</sup>

Difficult sectors, involving steel, vehicles, agriculture, and technical standards, are in need of restructure having been inherited from a period of central planning. It should be noted that



these areas are sectors which many other countries impede their free trade through subsidies, trade barriers, and other protections. Nevertheless, these areas are addressed given the separate issues surrounding them.

Steel production is an issue involving a number of countries and requires modernization. The United States is quick to bring charges of anti-dumping, given lobbying of its own producers, especially those of the heavily unionized and high cost entities. Russia is the largest exporter of steel and has suffered anti-dumping charges by the EU and the U.S. However, as previously discussed, steel is a sector that benefits from energy costs that are below the prevailing international rate. Thus, Russia is exposed to charges of unfair trading through energy subsidies. Russia needs to restructure the industry to include realistic energy costs and modernization efforts that will reduce energy and labor costs through efficiency. In fairness to Russia, a number of other countries need to address inefficiencies of their own steel industries.<sup>43</sup>

Modernization of automobile production has been slow. Although some western plants have been established, they face a number of barriers, and tariffs on imports remain high as an exception. The official Russian position is the sector should be protected and given time to modernize. The sector lacks technical expertise, management, and marketing skills for the design and production of new models. The WTO does favor the high tariffs as Russia works to restructure the industry; however, progress and resolution are expected. Some suggest the use of public monies, but this has the potential of continuing a state-trade relationship. The UK attempted state intervention in the 1970s and failed miserably. A number of foreign producers opened factories in the UK and have been quite successful in the production and sales of automobiles meeting world standards. Therefore, a wiser approach would be to open the market and encourage private investment—both domestic and foreign—rather than state-trade protectionism.<sup>44</sup>

Agriculture has not performed well. Climatic conditions are less than ideal for planting, cultivating, and harvesting in most regions. The lack of privatization and reforms has been the main culprit interfering with this sector. Laws have been passed to legalize land ownership, but with restrictions on foreign ownership. Despite these limitations, the reforms are beginning to produce positive results, as large farm concentrations that are either owned or leased are showing improvement, to include significant private investment. Unlike other countries, Russia provides comparatively small subsidies due, in part, to the government not being able to provide the money. This sector still needs modernization, to include private land ownership, distribution, and marketing.<sup>45</sup>

Technical standards represent a significant obstacle to trade over many sectors of imports and exports. The certification process is slow, cumbersome, and expensive and does not conform to international standards. Progress is being made, as one-third of the approximate 22,000 standards have been revised to comply with international standards. However, this transformation process will be slow and is expected to take a decade to accomplish, as a number of standards require some combination of legislative action or bureaucratic development.<sup>46</sup>

Services trade is not as sizeable as the previous issues. Services trade is a small fraction of Russian trade, but remains an issue as WTO members would like to see significant opportunity of this sector for foreign investment and trade, particularly in banking and insurance. These sectors are lacking in regulation with Russia desiring more time to reform and develop the services sector on its own. While the direction is right, the approach may be wrong in allowing Russia to develop these sectors on its own which will only delay needed improvements and development. This will cause investors to be reluctant to provide the FDI that would permit faster and better development. Improved services would provide better service to the Russian domestic and business communities and it would help attract FDI, as foreign investors could expect the same level of service they have in other parts of the world. These investors would also be more comfortable locating operations in Russia.<sup>47</sup>

Intellectual property rights (IPRs) are not as significant, particularly when compared to China, when it comes to pirating of CDs, software, videos and such. However, the U.S. lost over \$1 Billion in 2000 due to piracy and has had difficulty recording well-known trademarks. Russia does comply with formal international protocols regarding trade rights, but WTO members will expect improvement in the execution of procedures.<sup>48</sup>

The very low level of investment and capital flows through FDI has been already been noted, along with Russia's own FDI (capital flight) in other countries, particularly the CIS. Capital flight could be arrested by requiring export revenues to be deposited into the central bank and earmarked towards internal investment, but this is difficult to do and neglects the greater issue of a poor investment environment. The underlying cause is the need for sound macroeconomic management and institution practices that recognize private ownership, contracts, shareholder protection, even application and cooperation between federal and regional governments. The Russian record has not been good, but the Putin administration has taken a renewed pro-form direction, particularly since the 1998 crisis. Recognition of these shortcomings, the continued direction to improve the macroeconomic structure, along with the domestic institutional and policy reforms, should keep Russia heading in a direction to meet

WTO requirements. In the long run, this should attract the needed FDI and enable Russia to expand greatly beyond its current few revenue generating economic sectors.<sup>49</sup>

The Commonwealth of Independent States (CIS) was an attempt by Russia and its members to establish some form of economic integration among the CIS. The CIS established a free trade area (FTA). Still, various attempts among its various members to establish economic ties (for example, a Customs Union consisting of Russia, Belarus, Kazakhstan, Kyrgyzstan, and Tajikistan) have all produced little economic effect. Realistically, it would not benefit the CIS to be more affective. These groupings have been unable to affect agreements on tariffs and numerous obstacles, thus denying the real benefits of true real free-market growth and remaining burdened by out-dated, Soviet-era technology and practices. For example, it is cheaper to import Australian wine into Moscow than wine produced in Moldova.<sup>50</sup>

Russian intra-CIS trade will be affected by Russia's WTO membership. Russia would be required to revert to its MFN tariff structure rather than the CIS tariff structure and could not subsidize its energy trade in the region. Also, barter deals counter trade would have to be greatly reduced among less credit worthy countries. Instead, Russia would require monetary transactions.<sup>51</sup> Russia could request an exception, however, considering Russia's transition to a free-trade economy and its concomitant benefits, and that several of the CIS member-states are also applying for WTO membership, it would be in the longer term interests of Russia and the CIS not to seek such derogation. Beyond the CIS, consideration of Russian WTO membership and the European Union cannot be overlooked.

The Russian EU relationship is complex with a structured framework entered into through a 1997 agreement known as the Partnership for Cooperation and Agreement (PCA). The PCA framework envisages policy action and dialogue in: (a) trade and economic cooperation; (b) science, technology, and civil sector cooperation; (c) political dialogue; and (d) legal and domestic cooperation (e.g. drug trafficking, money laundering, organized crime, etc.). The trade and economic cooperation issues and interests between Russia and the EU are mutually reinforced by Russian WTO accession and will only further improve EU-Russia relations, as WTO accession will require reforms not only favorable to both parties but reforms beyond those of the EU. This will help further manage outstanding issues from the PCA between the EU and Russia.<sup>52</sup>

### Conclusion

Russia is a great power with significant potential to make even greater contributions to the world arena. Currently, she is: a member of the United Nations Security Council, a G-8 member

[and in accordance with the organization's charter, Russia will soon assume Presidency of the G-8], a partner in the multilateral negotiations with North Korea, a partner in the war on terror, and a country whose geography spans half the world's time zones. Russia also possesses nuclear and other weapons of mass destruction, has enormous high-tech and energy resources, and has great influence in the Middle East, Asia, and Central Europe. These contributions and potential for greater involvement are important to U.S. interests of Security for the Homeland and Promotion of Values.

Trade integration of Russia is necessary to exist in an era of liberal globalization. An economic secure Russia is a more willing ally towards the West and its values and, as a result, a counter to many otherwise potential threats. Through WTO accession, Russia is transitioning to a free-market economy. Through this transition come the reforms providing for transparency and accountability where none previously existed. In the end, Russia, the West, and other free market economies will find they have many common interests that mutually reinforce peace, prosperity, and freedom.

An economically secure Russia is in the best interests of the U.S. The U.S. has the opportunity to bolster its broad strategic objectives of Security for the Homeland and Promotion of Values and Economic Prosperity. WTO membership and trade relationships are not the most important matter. Instead, it is an aspect of a far greater objective of restoring order and demonstrating American commitment to its values of peace, prosperity, and freedom. In the final analysis, Americans can expect economic benefits of free trade with Russia, along with the more intangible and important opportunity of greater U.S. and global security. Rising prosperity, along with shared values and goals, provide unity of effort and dignity worth living.

#### Endnotes

<sup>1</sup> "Russia," <http://encarta.msn.com> © 1997-2005, Section VI, Government, page 13; available from [http://encarta.msn.com/encyclopedia\\_761569000\\_13/Russia.html#s50](http://encarta.msn.com/encyclopedia_761569000_13/Russia.html#s50); Internet; accessed 19 November 2005. The former Union of Soviet Socialist Republics (USSR) consisted of 15 republics. The Russian Soviet Federated Socialist Republic (RSFSR) was the largest of the 15 republics. It currently occupies the same territory as the former RSFSR.

<sup>2</sup> George Bush, *The National Security Strategy of the United States of America* (Washington, D.C. The White House, September 17, 2002), p iii-iv. [note: the opening letter is not numbered. It precedes the table of contents that begins with the page number of vii]

<sup>3</sup> Ibid., iv.

<sup>4</sup> Ibid., 17.

<sup>5</sup> Ibid., 17.

<sup>6</sup> The World Trade Organization, "The WTO in Brief," available at [http://www.wto.org/english/thewto\\_e/whatis\\_e/inbrief\\_e/inbr00\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm); Internet, accessed 8 November, 2005.

<sup>7</sup> The World Trade Organization, "Understanding The WTO: The Organization Members And Observers," [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org6\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm), internet, accessed 10 December 2005.

<sup>8</sup> Edward Gresser, "A View From Outside: Russia and the case for the WTO," See section on *Responsibilities and Domestic Reform* ; available at <http://www.russianamericanchamber.org/newsletter/aviewfromthe.html>; Internet, accessed 19 November, 2005. Note: This web site hosts The Russian-American Chamber of Commerce® a nonprofit, nonpartisan organization acting to promote American business interests in the Russian marketplace.

<sup>9</sup> Ibid., originally cited in Center for Economic and Financial Research Club 2015, "Russia in the WTO: Myths and Reality," available at [http://www.cefir.org/wto\\_pub.html](http://www.cefir.org/wto_pub.html) The Center for Economic and Financial Research (CEFIR) is a Moscow think tank contributing to the Putin Administration. In addition to the two points, the institute says: "An open economy is a key instrument in building constructive international relations. Trade and mutual investment make economies interdependent, limiting hostile manifestations of foreign policy. As a result, foreigners are perceived as professional peers, business partners, buyers and suppliers of goods and services – rather than as abstract enemies."

<sup>10</sup> U.S. Army War College Course Directive, "National Security Policy and Strategy," Academic year 2006, p. 114. The three national interests categories are derived from the three core interests of the United States as outlined in the appendix 1. The three categories are: (1) Security of the Homeland: protection against attack on the territory and people of a nation-state in order to ensure survival with fundamental values and political systems intact. (2) Economic Well-Being: attainment of the conditions in the world environment that ensure the economic well-being of the nation. (3) Promotion of Values: establishment of the legitimacy of or expansion of the fundamental values of the nation such as democracy and human rights.

<sup>11</sup> Peter Lavelle, Analysis: "Russia's Touchy WTO Bid" in an article for United Press International, published June 23, 2005.

<sup>12</sup> Keith Crane, D.J. Peterson, and Olga Oliker, "Russian Investment in the Commonwealth of Independent States," *Eurasian Geography and Economics*, 2005, vol 46, no.6, pp 405-444. [Note: The Commonwealth of Independent States is a confederation, or alliance, consisting of 11 former Soviet Republics : Armenia, Azerbaijan, Belarus , Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Ukraine, and Uzbekistan . Turkmenistan discontinued permanent membership as of August 26, 2005, and is now an associate member. The Baltic States of Estonia, Latvia, and Lithuania elected not to become members.]

<sup>13</sup> Ibid.

<sup>14</sup> Andrei Illarionov, "A Long-Term Project for Russia," *Russia in Global Affairs*, vol 3, no. 3 July-September 2005, p. 49-51. Andrei Illarionov is an Economic Advisor to the President of the Russian Federation. The article is based on a report made at the 8th Russia Economic Forum in London, April 11, 2005. "The prospects for long-term investment in Russia will take definite shape only when the country succeeds in the so-called entrepreneurial project. The successful development of business is the only format in which Russia can develop as a civilized and

successful country. A failure to embrace the entrepreneurial project means that from a strategic point of view Russia is doomed."

<sup>15</sup> Anonymous, "Measuring Globalization," *Foreign Policy*, May/Jun, p.56.

<sup>16</sup> U.S. Central Command, Statement before the Senate Armed Services Committee, Washington, DC 1 March 2005. Statement of General John P. Abizaid. The reference to Central Asian States was made with regard to continuing engagement of Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan and the CDR's addressing the instability of this region.

<sup>17</sup> Paul G. Hare, "Russia and the World Trade Organization," revised July 2002, page 3. This paper was written at the request of the Centre for European Reform (CER), London. Abstract: "Russia applied to join the WTO in 1993 and its accession is now making rapid progress, with possible entry in 2004. This paper discusses the economic and political factors associated with the Russian entry to WTO, focusing on tariffs, difficult sectors, services, IPRs and the environment for FDI. The impacts of WTO accession on Russia's domestic restructuring as well as on Russia's relations with the EU are also analysed. While recognising the delicate political conditions, the paper suggests that Russia should seek to comply with the standard requirements for WTO entry, and - subject to some transitional adjustment periods - should allow access to the Russian market for western services sector companies. WTO accession was seen as helpful to Russia in the sense of locking in reforms, and promoting further market-oriented reforms."

Although not cited in this SRP, but a useful source in affirming the economic body of literature on Russian WTO accession is: Harry G. Broadman, "Global Economic Integration: Prospects for WTO Accession and Continued Russian Reforms," MIT Press, The Washington Quarterly, Spring 2004 pages 79-98. Harry G. Broadman is lead economist, Europe and Central Asia Regional Operations, at the World Bank. This article draws in part from a paper prepared for "Sources and Limits of Russian Power," a seminar series cosponsored by the Center for Strategic and International Studies (CSIS) Russia and Eurasia Program and The Institute for National Strategic Studies (INSS), National Defense University.

<sup>18</sup> Hare, 7.

<sup>19</sup> Ibid., 7.

<sup>20</sup> Ibid., 8.

<sup>21</sup> Ibid., 9.

<sup>22</sup> Ibid., 9.

<sup>23</sup> Ibid., 10.

<sup>24</sup> Ibid., 11.

<sup>25</sup> Ibid., 10.

<sup>26</sup> Ibid., 11.

<sup>27</sup> *The United States Agency for International Development Home Page*; available from [http://www.usaid.ru/en/main/activity/index.shtml?activity\\_id=644](http://www.usaid.ru/en/main/activity/index.shtml?activity_id=644); Internet; accessed 25 February, 2006. Goal: "To frame a program that recognizes Russia's real development needs, its importance to U.S. strategic interests, its natural and human resources and its potential contribution to solving problems of global significance." Strategy: "[T]he program's principal foreign assistance goal is Support for a Strategic State. However, because of Russia's size, complexity and enormous regional variations the strategy contains sub-elements addressed to other White Paper goals as well: Transformational Development; Global and Transnational Issues; Humanitarian Response; and even Strengthening Fragile States. The program emphasizes building trust through cooperation, participation and linkages between American and Russian institutions. ..."

<sup>28</sup> *The United States Department of the Treasury Home Page*; available from <http://www.ustreas.gov/offices/international-affairs/>; Internet; accessed 19 November, 2005. "Treasury's Office of International Affairs protects and supports economic prosperity at home by encouraging financial stability and sound economic policies abroad. International Affairs performs constant surveillance and in-depth analysis of global economic and financial developments and then engages with financial market participants, foreign governments, international financial institutions, and in multilateral fora to develop and promote good policies."

<sup>29</sup> *Office of the United States Trade Representative Home Page* available from [http://www.ustr.gov/Who\\_We\\_Are/Mission\\_of\\_the\\_USTR.html](http://www.ustr.gov/Who_We_Are/Mission_of_the_USTR.html); Internet; accessed 20 November, 2005. "USTR is part of the Executive Office of the President. Through an interagency structure, USTR coordinates trade policy, resolves disagreements, and frames issues for presidential decision. USTR also serves as vice chairman of the Overseas Private Investment Corporation (OPIC), is a non-voting member of the Export-Import Bank, and a member of the National Advisory Council on International Monetary and Financial Policies."

<sup>30</sup> "U.S. Contributions to Trade Capacity Building," *Improving Lives Through Trade & Aid*, September 2003, p2. available from [http://pdf.dec.org/pdf\\_docs/PDABY500.pdf](http://pdf.dec.org/pdf_docs/PDABY500.pdf); Internet; accessed 25 February, 2006. "U.S. TCB efforts support the WTO and its technical assistance program as well as developing countries' efforts to address 'supply side' constraints affecting their participation in international trade."

<sup>31</sup> *Office of the United States Trade Representative Home Page* available from [http://www.ustr.gov/Trade\\_Development/Trade\\_Capacity\\_Building/Section\\_Index.html](http://www.ustr.gov/Trade_Development/Trade_Capacity_Building/Section_Index.html); Internet; accessed 25 February, 2006.

<sup>32</sup> Ibid.

<sup>33</sup> *Office of the United States Trade Representative Home Page* available from [http://www.ustr.gov/World\\_Regions/Europe\\_Middle\\_East/Russia\\_the\\_NIS/Section\\_Index.html](http://www.ustr.gov/World_Regions/Europe_Middle_East/Russia_the_NIS/Section_Index.html); Internet; accessed 25 February, 2006. From a 15 June 2005 news release entitled, "United States and Russia Sign Agreement on Meat Market."

<sup>34</sup> Home / Who We Are / USTR Mission; available from [http://www.ustr.gov/Who\\_We\\_Are/Mission\\_of\\_the\\_USTR.html](http://www.ustr.gov/Who_We_Are/Mission_of_the_USTR.html); Internet; accessed 12 January, 2006.

"American trade policy works toward opening markets throughout the world to create new opportunities and higher living standards for families, farmers, manufacturers, workers,

consumers, and businesses. The United States is party to numerous trade agreements with other countries, and is participating in negotiations for new trade agreements with a number of countries and regions of the world.

The Office of the U.S. Trade Representative (USTR) is responsible for developing and coordinating U.S. international trade, commodity, and direct investment policy, and overseeing negotiations with other countries. The head of USTR is the U.S. Trade Representative, a Cabinet member who serves as the president's principal trade advisor, negotiator, and spokesperson on trade issues.

USTR is part of the Executive Office of the President. Through an interagency structure, USTR coordinates trade policy, resolves disagreements, and frames issues for presidential decision. USTR also serves as vice chairman of the Overseas Private Investment Corporation (OPIC), is a non-voting member of the Export-Import Bank, and a member of the National Advisory Council on International Monetary and Financial Policies."

<sup>35</sup> "House Rejects, 338-86, Resolution for Withdrawing from WTO," 9 June 2005, available from <http://usinfo.state.gov/ei/Archive/2005/Jun/09-741522.html> [found under: [http://usinfo.state.gov/ei/economic\\_issues/WTO/wto\\_archive.html](http://usinfo.state.gov/ei/economic_issues/WTO/wto_archive.html)], Internet, accessed 25 November, 2005.

"In a 338-86 vote June 9, the House rejected a resolution that would have dropped Congress' approval for continued U.S. participation at the WTO. A similar resolution in 2000 failed by 363-56. ...The 1994 law that approved U.S. participation in the WTO gives any member of Congress the right once every five years to demand a vote by the full House or Senate on withdrawing from the WTO. ... Opponents of the resolution in the House argued in debate that continued participation in WTO negotiations remains the best way the United States has to work to open markets to U.S. exports and to promote enforcement of high labor and environmental standards."

See also [endnote 8]: [http://www.ustr.gov/Who\\_We\\_Are/Mission\\_of\\_the\\_USTR.html](http://www.ustr.gov/Who_We_Are/Mission_of_the_USTR.html)  
"Working with Congress--Since its creation, USTR has maintained close consultation with Congress. Five members from each House are formally appointed under statute as official Congressional advisors on trade policy, and additional members may be appointed as advisors on particular issues or negotiations. Liaison activities between the agency and Congress are extensive.

USTR provides detailed briefings on a regular basis for the Congressional Oversight Group, a new organization composed of members from a broad range of congressional committees. In addition, USTR officials and staff participate in hundreds of congressional conversations each year on subjects ranging from tariffs to textiles."

<sup>36</sup> World Trade Organization, Statement by H.E. Mrs Ermilinda Meksi, Minister of Economic Cooperation and Trade, 11 November, 2005; available from [http://www.wto.org/english/thewto\\_e/minist\\_e/min01\\_e/statements\\_e/st56.pdf](http://www.wto.org/english/thewto_e/minist_e/min01_e/statements_e/st56.pdf); Internet, accessed 26 November 2005.

<sup>37</sup> Gresser, see section on *Responsibilities and Domestic Reform* .

<sup>38</sup> Illarionov. p. 49-51.



<sup>39</sup> The Washington Times, National Weekly Edition, "Is the West Losing Russia," January 9-15, 2006, p. 36; and the Wall Street Journal, "Putin Adviser Resigns to Protest State Controls," 28 December, 2005, p A13.

<sup>40</sup> Ibid.

<sup>41</sup> Hare, 13.

<sup>42</sup> Ibid., 13.

<sup>43</sup> Ibid., 14.

<sup>44</sup> Ibid., 15.

<sup>45</sup> Ibid., 15-16.

<sup>46</sup> Ibid., 16.

<sup>47</sup> Ibid., 16-17.

<sup>48</sup> Ibid., 17.

<sup>49</sup> Ibid., 17.

<sup>50</sup> Ibid., 18.

<sup>51</sup> Ibid. 18.

<sup>52</sup> Hare. 21,22, and 28.

